Effective Date: June 19, 1995

**COORDINATED ISSUE**
**PARTNERSHIP INDUSTRY**
**SUBCHAPTER K ANTI-ABUSE RULE**
**REGULATION § 1.701-2**

## ISSUE:

Under what circumstances is the Commissioner of the Internal Revenue authorized under § 1.701-2 to recast a transaction involving the use of a partnership?

What procedure must Examination personnel follow if it is determined during the course of an examination that the application of § 1.701-2 may be appropriate?

## FACTS and LAW:

Final regulation § 1.701-2, 1995-7 I.R.B. 5, was issued on December 29, 1994. That regulation, along with Announcement 94-78, 1994-27 I.R.B. 124, provide the basis for this paper.

Subchapter K was enacted to permit businesses organized for joint profit to be conducted with "simplicity, flexibility, and equity as between the partners." S. Reg. No. 1622, 83d Cong., 2d Sess. 89 (1954); H.R. Rep. No 1337, 83d Cong., 2d Sess. 65 (1954).

It was not intended, however, that the provisions of subchapter K be used for tax avoidance purposes. For example, in enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if such concepts are more appropriate in applying other provisions of the Code. H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).

Similarly, in later amending the rules relating to special allocation, Congress sought to "prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes." S. Rep. No. 938, 94th Cong., 2d Sess. 100 (1976).

On May 12, 1994, the IRS and Treasury issued a notice of proposed rulemaking (59 FR 25581) under section 701 of the Code. That document proposed to add an anti-abuse rule under subchapter K. On December 29, 1994, the regulation was finalized. The regulation is expected to affect a relatively small number of partnership transactions that make inappropriate use of the rules of subchapter K. It is not intended to interfere with bona fide joint business arrangements conducted through partnerships.

**Application of Subchapter K Rules**

As set forth in § 1.701-2(b), the provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K. Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partner's aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

**Intent of Subchapter K**

Section 1.701-2(a) describes the intent of subchapter K. Generally, subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements:

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income).

Exception--Certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (a)(2) to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. Examples of such provisions include section 732, the elective feature of section 754, and the value-equals-basis rule in § 1.704-1(b)(2)(iii)(c), as well as regulatory de minimis rules such as those reflected in §§ 1.704-3(e)(1) and 1.752-2(e)(4). In determining whether a transaction clearly reflects the partners' income, the principles of sections 446(b) and 482 apply.

**Facts and Circumstances**

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partner's aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified below or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was, or was not, used in such a manner. Factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the

partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or related party).

**Recast Transactions**

If it is determined that a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the transaction is recast as appropriate to achieve tax results that are consistent with the intent of subchapter K. Even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K:

(1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;

(2) One or more of the purported partners of the partnership should not be treated as a partner;

(3) The methods of accounting used by the partnership or partners should be adjusted to reflect clearly the partnership's or the partner's income;

(4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or

(5) The claimed tax treatment should otherwise be adjusted or modified.

**Abuse of Entity Treatment**

Section 1.701-2 also provides a rule for abuse of entity treatment. Under § 1.701-2(e), a partnership is treated as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations unless a provision of the Code or regulations, prescribes the treatment of the partnership as an entity (in whole or in part) and that treatment and the ultimate tax results - taking into account all the facts and circumstances, are clearly contemplated by that provision. The Commissioner's authority to treat a partnership as an aggregate of its partners is not dependent on the taxpayer's intent in structuring the transaction. Underlying the promulgation of paragraph (e) is the belief that significant potential for abuse exists in the inappropriate treatment of a partnership as an entity in applying rules outside of subchapter K to transactions involving partnerships.

**Scope and Application**

Section 1.701-2 applies solely with respect to taxes under subtitle A of the Code (generally, income taxes). Any reference in to a tax in § 1.701-2 is limited to a tax imposed under Subtitle A. Therefore, examples 5 and 6 in the regulation as originally finalized have been deleted. No inference is intended as to the treatment under current law of transactions not covered by the regulation.

**Effective Date**

Section 1.701-2 generally applies for all transactions involving a partnership that occur on or after May 12, 1994, except that the rule for abuse of entity treatment, paragraph (e), applies for transactions on or after December 29, 1994. Paragraph (i) clarifies that the Commissioner can continue to assert and to rely upon applicable nonstatutory principles and other statutory authorities to challenge transactions. If a transaction occurred prior to the effective date, consider whether it conforms to established legal doctrines such as the business purpose and substance over form doctrines, including the step transaction and sham transaction doctrines.

**Announcement 94-87**

Many comments in response to the proposed regulation expressed concerns that, once finalized, Examination personnel would be unable to apply the provisions uniformly. Announcement 94-87, 1994-27 I.R.B. 124, advised taxpayers that when an issue that may be affected by the regulation is considered on examination, any application of the regulation must be coordinated with both the Issue Specialist on the Partnership Industry Specialization Program team and the National Office. This coordination will result in fair and consistent treatment of taxpayers in the application of the regulation to partnership transactions. Therefore, if an examiner determines that § 1.701-2 may apply, the examiner must contact the Partnership Industry or Issue Specialist. It will be the responsibility of the specialist to coordinate with the National Office.

**SUMMARY:**

Under certain circumstances, the Commissioner of Internal Revenue is authorized to recast transactions involving the use of partnerships that are inconsistent with the intent of Subchapter K.

Examiners should be aware that when an issue is considered under § 1.701-2, the Partnership Industry or Issue Specialist must be contacted. The Partnership Industry or Issue Specialist will coordinate application of the regulation with the National Office.